Mintues-of-Use Calculation (See Footnote 71 of the Order)

Z-Tel, in Equation 2 of Attachment A, of its Reply Brief on Exceptions, characterizes Verizon's traffic-sensitive switching cost (TSSC) estimate as

$$TSSC = \frac{COST}{BDMOU \times 251}$$

However, it would be helpful to re-characterize the left-hand side of the equation as traffic sensitive switching cost per annual business day minute of use (MOU).

$$\frac{TSSC}{ANNUALBDMOU} = \frac{COST}{BDMOU \times 251}$$

Verizon, page 20 of its Brief on Exceptions, indicated that the traffic sensitive switching cost element should be applicable to all billable MOUs. The following equation summarizes the total annual billable MOUs per year [business day (BD) MOUs plus weekend/holiday day (WHD) MOUs].

$$ANNUALMOU = ANNUALBDMOU + ANNUALWHDMOU$$

where

$$ANNUALBDMOU = BDMOU \times 251$$

and

$$ANNUALWHMOU = WHDMOU \times 114$$

In order to produce a unit cost that, when applied to all billable MOUs, produces revenues equaling the total traffic-sensitive investment cost, the annual business day MOUs in the denominator of the second equation above must be multiplied by the ratio of total annual MOUs to annual business day MOUs.

$$\frac{TSSC}{ANNUALBDMOU} \times \frac{1}{\frac{ANNUALMOU}{ANNUALBDMOU}} = \frac{TSSC}{ANNUALMOU}$$

Since

$$\frac{ANNUALMOU}{ANNUALBDMOU} > 1$$

the unit cost per MOU must be lower than Verizon's methodology indicates.

$$\frac{ANNUALMOU}{ANNUALBDMOU} = \frac{(BDMOU \times 251) + (WHDMOU \times 114)}{BDMOU \times 251}$$

VERIZON NEW YORK INC.
Summary of Commission Adjustments
To Verizon's Recommended Decision Compliant Rate Filing

Note - The adjustments listed below include the revisions needed to reflect the modifications to the Recommended Decision discussed in the text of the opinion as well as correction of technical errors found during Staff's review of Verizon's Recommended Decision compliance filing. The latter are not discussed in the text of the opinion.

SWITCHING

1. Allocate 66% of end office (EO) switch material costs to non-traffic sensitive (NTS) switch UNE's and 34% to traffic sensitive (TS) switch UNE's.

INVESTMENT LOADING FACTORS

1. Reduce the denominator of the land and building factor by $466,893,554 to reflect the subtraction of Remote Terminal equipment investment in Account 2232 (Circuit Equipment CPE) per Verizon's original (2/7/00) workpaper Part H, section 1, page 1, line 15, column d.

2. Increase the Engineer, Furnish and Install (EF&I) factor will be increased from 30% to 40%.[1]

ANNUAL COST FACTORS (ACF)

1. Reduce the general productivity factors for maintenance and non-network related expenses from 3% and 12%, respectively, to 2% and 10%.

2. Adjust the Forward Looking to Current Factor (FLC) from 75% to 65%.

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[1] The EF&I factors for end office and tandem switching should be calculated in the manner proposed by Verizon in its Brief on Exceptions compliance and the material prices adopted by the Commission.

VERIZON NEW YORK INC.

Summary of Commission Adjustments
To Verizon's Recommended Decision Compliant Rate Filing

3. For the poles and conduit Network ACF only, reflect reversal of the Recommended Decision's 30% reduction to the Moves & Rearrangement (M) dollars.

4. Recalculate the Wholesale Marketing, Other Support and Network ACFs so that the denominators include an estimate of Splitter Investment not owned by Verizon.

5. Increase the Common Overhead ACF to reflect a $60 million allowance for Special Pension Enhancement (SPE) payments by including that amount on Verizon's original (2/7/00) workpaper part H, section 3.11, page 4 of 5, line 4.

6. Adjust the Return, Interest and Federal Income Taxes ACF's to reflect the following cost of capital.

	%	Cost	Rate of Return
Debt	35%	7.3%	2.6%
Equity	65%	12.1%	7.9%
Total	100%		10.5%

7. Adjust the depreciation ACFs to reflect the depreciation lives and net salvage values in Verizon's original (2/7/00) filing.

8. Use the forward-looking cost of capital for the cost of capital input into the "support capital cost model".

LOOPS

1. Reverse the adjustments that applied the land and building loading factor to all central office equipment investment. (See Exhibit 333P [Exhibit AH-1 at 1], adjustment 5, sheets OSP-96, OSP-192, OSP-672, OSP-1344, 16CEV, 16 CEMH, 24CEV, 24 CEMH, PCH-1, PCH-2, IT-RR and IT-CPE).

2. Reflect one-half the Recommended Decision's adjustments to normalize the environmental factors used in the link cost calculator.

VERIZON NEW YORK INC.
Summary of Commission Adjustments
To Verizon's Recommended Decision Compliant Rate Filing

3. Reflect one melded loop rate for all loops based on the latest month's UNE-P (IDLC) and UNE-L (UDLC) lease quantities.

4. Reverse application of the 4:1 GR303 concentration ratio to universal interfaces and DS-1 central office terminals.

5. Reverse the 100% conduit fill factor for innerducts applied to conduit containing copper distribution cable.

6. Reduce the power investment factor input into the link cost calculator to reflect the appropriate rate (.018085).

HOUSE AND RISER CABLE

1. Decrease the fill factor from 60% to 55%.

INTEROFFICE TRANSPORT

1. Reflect the Recommended Decision's adjustment to reflect a weighted-average distance of 12 miles between wire centers (versus 33.4 miles) for Common (Shared) Transport. See workpaper part B-2, section 3, pages 1 and 2, line 3.

2. Increase the fill factor for dedicated transport from 80% to 85%.

NON RECURRING CHARGES (NRC)

1. For UNE-P ports only, reverse the Recommended Decision's adjustment to reflect a 2% fallout rate.

2. Reflect the Recommended Decision's adjustment reducing the NRC rate for "ADSL Conditioning - Manual Loop Qualification" and "ADSL Conditioning - Manual Loop Qualification Expedite" by 25%. See Verizon exhibit M, section 1, page 1 of 1.

Attachment 4

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

At a session of the Public Service Commission held in the City of Albany on February 27, 2002

COMMISSIONERS PRESENT:

Thomas J. Dunleavy, Presiding
James D. Bennett
Leonard A. Weiss

CASE 00-C-1945 - Proceeding on Motion of the Commission to Consider Cost Recovery by Verizon and to Investigate the Future Regulatory Framework.

CASE 98-C-1357 - Proceeding on Motion of the Commission to Examine New York Telephone Company's Rates for Unbundled Network Elements.

ORDER INSTITUTING VERIZON INCENTIVE PLAN

(Issued and Effective February 27, 2002)

BY THE COMMISSION:

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INTRODUCTION

When we instituted the Verizon New York Inc. (Verizon) regulatory proceeding in November 2000, the Commission intended an examination of the emergence and status of the competitive market for local telecommunications service in New York, with concomitant modifications to the Verizon Performance Regulatory Plan then in effect. This proceeding, along with the concurrent litigation of wholesale rates in Case 98-C-1357, encompassed the range of issues fundamental to establishing a framework for the next generation of local competition in New York, as envisioned by the Telecommunications Act of 1996 (the 1996 Act). In November 2001 we asked the parties to this proceeding to explore the possibility of a comprehensive joint proposal for the Commission to consider integrated solutions to the closely intertwined issues of a distressed competitive marketplace, Verizon's retail prices, service quality protections, incentives to invest in New York's infrastructure, and the public interest in promoting all forms of competition.[1] We gave the parties 60 days. On February 8, 2002, Verizon and Department of Public Service Staff (Staff) filed a Joint Proposal Concerning Verizon Incentive Plan (VIP or Plan), attached to this order as Appendix A. Most competitors joined them.

We find the terms and provisions of the Joint Proposal, in the context of our wholesale rate decision issued in January 2002, to provide a proper balancing of the interests of customers, competitors, the incumbent, and the economic development of New York State and to produce just and reasonable rates with a guarantee of safe and adequate service. We adopt the terms of the Joint Proposal as discussed herein, and put in place a Verizon Incentive Plan to create the framework and conditions to allow and encourage all forms of competition in New York. The retail rate flexibility that we accord Verizon by this order is premised upon the existence of such competition and on the continuation of adequate service.

[1] Cases 00-C-1945 *et al*, Order Granting Staff Motion (issued November 30, 2001).

PROCEDURAL HISTORY

In November 2000 we instituted a proceeding "to resolve outstanding issues regarding the recovery of certain costs sought by Verizon New York Inc.; to consider the potential modification of [Verizon's] Performance Regulatory Plan (PRP), pursuant to conditions included in our approvals of its past mergers; and to consider emerging issues related to the development of a vibrant competitive marketplace and the future regulatory regime that may be appropriate following the conclusion of the PRP."[2] The first step in that process, as contemplated in our order, was the issuance by Staff, on January 2, 2001, of a White Paper setting forth its analysis of the exogenous costs and competitive cost onsets that might be recoverable by Verizon under our orders approving the two mergers (NYNEX/Bell Atlantic and Bell Atlantic/GTE) that led to its formation.[3]

In a series of rulings that reflected, in part, a conference with the parties held on February 13, 2001, Administrative Law Judges Joel A. Linsider (Litigation Judge), Jaclyn A. Brilling and Eleanor Stein (Settlement Judges) invited comments on the Staff White Paper and elaborated on the scope of and schedule for the proceeding.[4] Comments and reply comments on the White Paper were duly filed and, consistent with the judges' rulings, Verizon on May 15, 2001 filed its financial data and a proposal, with supporting testimony, for a future regulatory plan. Presentations by other parties were to be filed on

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[2] Case 00-C-1945, Order Instituting Proceeding (issued November 3, 2000), pp. 1-2.

[3] Cases 96-C-0603 et al., NYNEX/Bell Atlantic Merger, Opinion No. 97-8 (issued May 30, 1997); Case 98-C-1443, Bell Atlantic/GTE Merger, Order Granting Approval of Merger (issued August 12, 1999).

[4] Case 00-C-1945, Ruling Inviting Comments and Convening Conference on the Scope of the Proceeding (issued January 2, 2001); Ruling on Scope and Schedule (issued February 27, 2001); Ruling on Request for Clarification (issued April 6, 2001).

August 13 but, by letter dated August 1, Verizon requested that discussions be initiated and that the litigation schedule be suspended. In a ruling issued August 6, Judge Linsider suspended the litigation schedule.

The parties' discussions were scheduled to begin on September 11, 2001 in New York City. That meeting was of course cancelled as the terrible events of that day unfolded, and talks were postponed to allow Verizon and other parties to direct all their efforts to recovery. Discussions resumed in December 2001 and continued into early February 2002, with Judge Stein serving as mediator throughout. Participants are listed in Appendix B.

Concurrently the final stages of litigation were going forward in Module 3 of the Second Network Elements Proceeding (Case 98-C-1357), an examination of the pricing of Unbundled Network Elements (UNEs). A recommended decision had been issued in May; briefs and reply briefs on exceptions had been filed, and the case was being prepared for presentation to us. That process as well was delayed by the September 11 attack, and we invited parties to submit comments on the extent, if any, to which the attack and its aftermath might have a bearing on the issues in that case. We later granted a Staff motion to hold the UNE rate decision in abeyance and consolidate UNE issues with the resumed discussions in this proceeding, but we limited that process to 60 days.[5] A joint understanding incorporating UNE rates generally was not reached, and we considered UNE rates at our January session and issued our decision on January 28, 2002.[6] In that decision, we remanded for further discussion among the parties the issue of potential refunds resulting from the decrease in previously temporary rates for switching elements. Intensive mediated efforts in this proceeding continued, ultimately producing the Joint Proposal here before us for consideration.

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[5] Cases 00-C-1945 and 98-C-1357, Order Granting Staff Motion (issued November 30, 2001).

[6] Case 98-C-1357, Order on Unbundled Network Element Rates (issued January 28, 2002)(UNE Order).

Following its submittal by Verizon and Staff, the Joint Proposal was executed as well by ACC Telecom Corp., Allegiance Telecom of New York, Inc., AT&T Communications of New York, Inc. (AT&T), BridgeCom International (BridgeCom), Broadview Networks (Broadview), Communications Corporation of New York, Conversent Communications of New York, LLC, Focal InfoHighway Communications Corp. (InfoHighway), RCN Telecom Services, Inc., Talk America, Inc., TCG New York, Time Warner Telecom (Time Warner), XO New York, Inc. and Z-Tel Communications, Inc. (Z-Tel). Statements supporting the Joint Proposal were submitted by Verizon, Staff, Worldcom, Z-Tel, BridgeCom, and Cablevision Lightpath; Covad stated it did not oppose. Responsive comments were submitted by the Attorney General, CompTel, PULP, Assemblyman Richard Brodsky, and ChoiceOne. An evidentiary hearing before Chairman Helmer and Chief Administrative Law Judge Judith A. Lee was held in Albany on February 19, 2002; the record comprises 671 pages of stenographic transcript and 15 exhibits. At the conclusion of the hearing, closing statements in lieu of initial briefs were presented by PULP, the Attorney General, AT&T, WorldCom, Allegiance, Focal, Time Warner, Z-Tel, BridgeCom, William Thornton on behalf of Assemblyman Richard Brodsky, Verizon and Staff. Replies were submitted by Staff, Verizon, PULP, and BridgeCom. In addition, public comments were received via a special channel on our toll-free opinion line and by e-mail via the comment form on our website.

SUMMARY OF THE JOINT PROPOSAL[7]

The proposed Verizon Incentive Plan (VIP) would have a term of two years, beginning March 1, 2002. The associated Service Quality Plan (SQP) would extend an additional year, through February 28, 2005. The VIP and SQP would govern

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[7] This summary is provided only for the reader's convenience and in no way supersedes or modifies the terms of the Joint Proposal itself. It is not exhaustive, and an omission of a reference to any particular term of the Joint Proposal is of no import.

Verizon's retail and wholesale rates; relations with its competitors; service quality; accounting, pension, and other regulatory matters; and infrastructure.

The following findings, expectations, and requirements are premises of the plan:

- Verizon's service quality performance is generally satisfactory, and a service quality plan is in place to prevent backsliding.
- Active competition will exist across all market segments.
- Unbundled network element (UNE) rates will be as set in the UNE Order.
- The UNE Platform (UNE-P) will remain available in accordance with then-Bell Atlantic-New York's April 6, 1998 Pre-Filing Statement (PFS) as here modified.
- Facilities-based competition will continue to develop.

Rates

The VIP affords Verizon flexibility with respect to its rates, subject to specified conditions, exclusions, and limitations. General conditions of pricing flexibility include the following:

- The overall revenue increase associated with pricing flexibility may not exceed 3% on an annualized basis in each Plan Year.
- Pricing flexibility may be suspended pursuant to the terms of the Service Quality Plan.
- Verizon must take full responsibility for explaining to its customers the need and rationale for any price increase and must explain that the price increase is based solely on its own business decision.
- Downward rate flexibility is unlimited, except that the rate for any product or service must exceed or equal its

incremental cost and usage offerings must pass an imputation standard.

Verizon will be afforded upward rate flexibility for all products and services consistent with the Service Quality Plan <u>except</u> the following:

- Carrier access services
- UNEs
- Wholesale discounts for services offered for resale
- Interconnection and reciprocal compensation
- Lifeline services
- Maintenance and access to the ALI database
- Directory assistance and other database inquiries for competitive providers
- Non-recurring service connection charges for residential and small business customers
- Certain services previously ordered to be provided at no charge.

Where upward rate flexibility applies, there is no cap on the rate for any individual service <u>except</u> that:

- No increase in the charges for First Line Basic Service shall exceed $1.85 per line in the first year and $0.65 per line in the second year.
- The total price for 1FR service[8] in Rate Group 1 shall not increase by more than $2.00 in the first year of the Plan and $2.00 in the second year of the Plan.
- The total price for 1FR service in Rate Groups 3 and 5 shall not increase by more than $2.00 in the first year of the Plan and $3.00 in the second year of the Plan.

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[8] This service is a residential service consisting of the basic line charge and flat-rate local usage.

Unbundled Network Elements

For the term of the VIP, and regardless of any changes in its obligations under federal law, Verizon will make the UNE Platform available to CLECs serving small business customers on the pricing and duration terms applicable, under its PFS obligations, to CLECs serving residential customers.

Rates for UNEs are those set in the UNE Order, as specifically set forth (with respect to the main UNEs and the UNE-P) in Appendix A to the Joint Proposal, and Verizon will not contest those rates, either before us or in court. The sole exception to those rates is that the non-recurring charge for two-wire and four-wire hot cuts will be limited to $35. (The difference between the higher charge set in the UNE Order and the $35 charge under the VIP will be applied as a bill credit.) That limitation, agreed to by Verizon in order to arrive at a joint proposal, is part of the proposed treatment of refunds on account of the switching rates kept temporary in the First Network Elements Proceeding; other aspects of the refund treatment are as follows:

- Verizon will provide a "Forward Fund" of $15 million that will satisfy any potential liability for refunds, net of any reciprocal compensation payments due and owing to Verizon.
- Payments will be made only to CLECs that operate within the State; that paid the temporary switching rate; whose hot cuts in 2001 did not exceed 5,000; and that relinquish any other claims for retroactive payments related to switching rates.
- The Department of Public Service will conduct an expedited process to allocate the Forward Fund among eligible CLECs. Payments to CLECs will be 50% in the form of direct payments and 50% in the form of bill credits over a six-month period.
- Verizon will give up any claim to recovery of reciprocal compensation overpayments on account of excess switching rates.

Competitive Enhancements

Verizon agrees to cooperate in a task force that will work toward establishing processes and procedures to standardize efficient wholesale transactions in several specified areas including billing and collection, building access, and efficient provisioning for services where no facilities are available. The task force will report to us within three months of the issuance of this order.

Verizon will also participate in a task force to work with CLECs and Staff to solve urgent facilities, hot-cut and other bottleneck problems. That task force will report to us within six months.

Service Quality

The Service Quality Plan establishes a series of performance objectives, compliance with which is to be periodically reviewed. Failures to meet objectives are subject to various outcomes, depending on the nature and severity of the failing. These include suspension of pricing flexibility and rate credits of up to $100 million for failure to meet three objectives plus $35 million for each additional objective not met. The Plan includes detailed provisions for the calculation and distribution of these payments. In addition, Verizon undertakes to pay $100,000 into the State's general fund in the event of certain major service interruptions and to implement a special services process improvement program. The Plan details procedures to ensure the accuracy of service quality measurement.

Financial Consistency and
Additional Regulatory Protections

The VIP provides for Verizon's PSC regulatory financial figures and depreciation reserve to be gradually conformed to those used in its filings with the Securities and Exchange Commission. Existing regulatory assets and liabilities are to be extinguished by the end of the VIP's term and no new ones are to be created except with respect to World Trade Center restoration. Any changes to Generally Accepted Accounting Principles (GAAP) are to be adopted for both SEC and state regulatory purposes under the plan.

Verizon will account for pensions and other post-employment benefit (OPEB) obligations in accordance with SFAS #87 and SFAS #106. In addition,

- Verizon will not withdraw plan assets other than to pay benefits (including administrative expenses) or settle benefit obligations associated with pension and OPEB plans.
- Verizon will not annuitize, curtail, or otherwise settle its pension or OPEB obligations to employees of regulated entities in New York without our prior approval.
- Verizon will notify us of major changes in pension or OPEB plans, material changes in assumptions, or use of plan benefits for purposes other than pensions and related administrative expenses.

Infrastructure

To ensure investment commensurate with good service quality, Verizon will

- File annual construction budgets that identify service-related investments
- Meet annually with Staff to review its construction budget, with emphasis on several specified areas

- Report annually on plans and progress related to new technology and new services.

To ensure reliability consistent with post-September 11 best practices, Verizon will

- By July 1 of each year, inform Staff of its intention to implement changes, reflecting lessons learned from incidents such as the September 11 attack, to the Network Reliability and Interoperability Council's best practices and industry standards; and report annually to Staff on its progress toward implementation

- Participate in industry/government forums on network reliability

- Cooperate in developing data to be used by Staff in its Geographic Information System designed to provide service outage information.

Miscellaneous Provisions

The Joint Proposal would resolve outstanding issues related to exogenous cost recovery and merger savings (the so-called "White Paper" issues). It would have us find that available merger savings fully offset otherwise allowable cost onsets and exogenous costs; and that ordering clauses 5 and 6 of the orders approving the NYNEX/Bell Atlantic merger and the Bell Atlantic/GTE merger had been satisfied such that Verizon relinquishes any claim to rate increases associated with exogenous costs and that merger savings will not be used as a basis for rate reductions. Verizon likewise would withdraw its recent request for recovery of OSS costs associated with various DSL-related items.

The Joint Proposal includes a provision reserving our authority to act on the level of Verizon's rates and service should circumstances render Verizon's rates unjust or unreasonable or render the Plan unreasonable, unnecessary or insufficient for the continued provision of safe and adequate service by Verizon. In addition, Verizon agrees not to challenge the rates set in the UNE Order before us or in court, during the term of the plan, though it does not thereby relinquish any rights elsewhere with respect to the underlying theory of the case, including the use of TELRIC costing.

The Joint Proposal would defer, to the end of the VIP's term, the review of rates for the loop/switch interface that would otherwise take place, pursuant to the UNE Order, in May 2002.

Verizon agrees to reduce the connection charge for Lifeline service from $10 to $5. In addition, it will maintain an outreach and education program for Lifeline. More generally, it will design and carry out, within existing consumer education budgets, a commitment to inform customers about their rights, responsibilities and special programs.

RECORD EVIDENCE AND STATEMENTS IN SUPPORT

Verizon

In testimony submitted with the Joint Proposal, Verizon characterizes the plan as "an important step toward establishing appropriate incentives for Verizon NY and other carriers to invest in and develop telecommunications facilities in the State of New York and to engage in full-fledged competition, governed by market forces and not unduly restrained by regulation."[9] It regards the plan as especially important following issuance of the UNE Order which, it asserts, imposes regulatory constraints on Verizon's wholesale business that make it even more important for Verizon to be able to compete on a level footing in the retail marketplace. Verizon believes as well that its good service quality performance warrants revisiting its service quality obligations and that conforming its regulatory financial reports to its SEC reports properly reflects the competitive marketplace. Verizon regards the VIP as consistent with our "policy of substituting market discipline for direct regulatory intervention where there is evidence, as there is here, that such market discipline will have the desired

[9] Verizon's Prefiled Testimony, p. 7.

effect,"[10] but adds that the plan maintains adequate regulatory safeguards even as it allows Verizon increased flexibility to respond to market forces.

With reference to the Plan's pricing flexibility, Verizon contends generally that the growth in competition in the New York telecommunications market obviates detailed price regulation; that pricing flexibility benefits consumers by enabling Verizon to deploy pricing plans more responsive to consumer needs; and that Verizon needs pricing flexibility to respond to its competitors, who already have virtually total pricing flexibility. It urges elimination of asymmetric regulatory constraints that, in its view, prevent competitors from charging cost-based prices, encourage market inefficiencies by allowing its competitors to capture customers simply by reason of their regulatory advantages, and diminish the incumbent's ability to innovate. Verizon adds that affording it the opportunity to compete and obtain a reasonable return on its investment is particularly important in view of the UNE Order, which makes entry more attractive to other carriers. It adds that only the prospect of adequate levels of return will provide it the economic rationale to invest in its network, which makes up a substantial part of the State's telecommunications infrastructure. At the same time, strong and increasing competition will preclude Verizon from profitably raising prices above competitive levels, and increases in the charges for first line basic service are limited.

More specifically, Verizon argues that the 3% annual limit in increased annual revenues is reasonable, among other things, in light of the trend of change in cost of living. It notes that the 3% is a ceiling, that rate increases are not required, and that they would be imposed only if Verizon concluded that the market warranted them. It asserts that the relatively small increase allowed in basic service rates, even if applied, would still leave telephone service affordable; that increased competition benefits consumers by providing them more

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[10] Id., pp. 9-10.

choice and better value; and that Lifeline rates will not be raised and that the Lifeline connection charge will in fact be reduced to $5.

Verizon estimates the following revenue effects in 2002 associated with price changes under the VIP[11]:

Rate Change	Revenue Effect in 2002
$1.85 per line increase	$120.6 million
Other changes up to 3% maximum	$15.3 million
New UNE-P and UNE-L rates	($227.2 million)
Switching rate refund	($15 million)
Credit on hot cut NRC	($2.5 million)

Verizon includes with its filing financial projections for the years 2002-2004[12] and suggests that its calculated returns are below any fair and reasonable range of returns that we might set in a rate case and are, in fact, optimistic: they contemplate exercise of the full 3% pricing flexibility, which might be precluded by market conditions; they assume payment of no service quality penalties; and they are based on the earlier projections, filed May 15, 2001, which are likely to prove optimistic in light of economic conditions generally and the aftermath of the September 11 attack.

With regard to service quality, Verizon notes that it has made substantial investments to meet or exceed the service quality standards imposed under the performance regulatory plan about to expire and that the new three-year service quality plan (SQP) associated with the VIP insures continued high-quality service. In contrast to the PRP service plan, which was designed to encourage the capital investments needed to improve service, the VIP service quality plan recognizes the improvement that has been achieved and is designed to prevent backsliding from those levels. Pointing to the SQP's statewide performance objectives, the availability of credits for customers if those objectives are not met, and our authority to suspend pricing

[11] Verizon's Prefiled Testimony, pp. 33-34.

[12] Id., pp. 17-18.

flexibility if two performance objectives are missed in a single review period beginning on or after February 28, 2003, Verizon explains that the plan uses regulation to set minimum service quality standards but that competitive forces will likely require all market participants to exceed that regulatory floor. Verizon notes that the SQP is designed to prevent poor performance in any part of its service area, explaining why it believes the performance objectives to be appropriate, and describing how the enforcement mechanisms--payments and the potential suspension of pricing flexibility--are crafted in a way that will require consistently high levels of service quality. It notes as well that the provisions to ensure accurate service results borrow heavily from the analogous provisions of the PRP but include a number of new items, among them a process being developed with the Communications Workers of America for the investigation of allegations of service misreporting.

Verizon explains that the plan to conform its PSC books to GAAP accounting is warranted because the increasingly competitive telecommunications market obviates the separate accounting records associated with a rate-base/rate-of-return regulatory regime. The transition's effect on customers, if any, would be a benefit associated with the write-off of a substantial amount of rate base through accelerated depreciation.

Overall, Verizon asserts that the VIP ensures high-quality services at affordable prices, and provides Verizon NY with the flexibility it needs to compete in today's market and with the incentives to continue to invest in New York.

<u>Staff</u>

Staff believes the Joint Proposal "is both in the public interest and consistent with the Commission's pro-competitive and economic development policy initiatives."[13] The Plan's goals, according to Staff, include the stimulation of

[13] Staff's Prefiled Testimony, p. 3.

competitive market forces so that customers benefit from investment in new technology, which produces innovation and choice. Staff expects competition will discipline prices in a manner that will permit customers to avoid the price increases authorized by the VIP should Verizon put them into effect. The expanded availability of UNE-P for small business customers and benefits for UNE-L competitors will introduce greater competition into the small business market and strengthen opportunities for economic development. The special services process improvement program will improve provisioning performance for high capacity circuits, thereby aiding economic development. The retail service quality and infrastructure components of the VIP preclude Verizon from enhancing its earnings by sacrificing good service quality, while the existing performance assurance plan continues to ensure high wholesale service quality for CLECs. The plan includes additional protections for Lifeline customers as well as an outreach and education program related to special programs.[14]

Staff expects the competitive enhancement task forces created under the plan will improve operating relationships between Verizon and its competitors. In addition, the financial consistency terms of the VIP will move Verizon's accounting and financial reporting to a method that reflects the actual competitive environment. Staff suggests that the reduced wholesale prices required by our UNE Order will increase local service competition around the State and across all customer groups, thereby warranting reduced regulation of Verizon's own retail rates and the price flexibility provided for in the VIP.

Staff identifies several features of the Plan that, in its view, well serve the public interest. Among them are the offering of the UNE platform to CLECs serving small business customers; the establishment of task forces to deal with issues that interest and concern CLECs; the improved provisioning and maintenance of special services; and the price flexibility afforded Verizon. Price flexibility is in the public interest,

[14] Staff's Prefiled Testimony, pp. 3-5.

Staff continues, because it will allow rates to move gradually to costs; because Verizon's return on equity will likely fall within a reasonable range for companies with similar risk profiles; and because customers may be able to avoid any price increases by looking to competitive providers. Staff points as well to the Plan's resolution of the switching rate refund issue and to its reduction of the non-recurring charge for hot cuts, additional steps that will contribute to the growth of competition.

Staff believes that the Plan will promote economic development, suggesting the Plan will advance economic development by enhancing competition; creating strong incentives for Verizon to maintain its improved service quality; encompassing a separate agreement by Verizon to improve the provisioning of special services,[15] which are critical to the State's information-based economy; and relaxing rate regulation. With specific reference to special services, Staff notes inadequacies in Verizon's past performance[16] and explains that Verizon has now agreed to introduce a management program designed to improve its provisioning performance and to insure that the services are properly maintained once in place. The program includes customer credits in the event of below-target performance and is designed to gradually improve service.

Staff places the pricing flexibility provisions of the VIP in the context of a telecommunications market that has become steadily more competitive and in which traditional rate regulation is no longer necessary. The caps on pricing flexibility reflect Verizon's continued position as the dominant, though no longer monopoly, provider of telecommunications service. Staff cites past actions by the Commission allowing pricing flexibility as markets have opened, such as with respect to terminal equipment.

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[15] Special services are a variety of dedicated point-to-point private lines services generally used by business for the transport of data and voice traffic.

[16] Citing Cases 00-C-2051 et al., Opinion No. 01-1 (issued June 15, 2001).

Staff offers a financial analysis explaining how Verizon's rates under the plan will be just and reasonable. It sees no basis for concern about Verizon achieving an excessive return over the course of the Plan, citing, among other things, competitive pressures on that return. Taking account of the reduced UNE rates and anticipated revenue increases associated with the Plan, Staff estimates, on Verizon's premises, earnings of 2.8% in 2002, 6.4% in 2003, and 4.6% on average.[17] With Staff's traditional rate-case type adjustments, those figures become 11.4%, 16.3% and 13.9%.[18] Staff suggests that a traditional regulatory model might have produced an authorized return only in the range of 11% to 12% rather than its forecast 13.9%, but it believes that the overall result is reasonable in view of Verizon's specific risk profile (which might have suggested a return at the 12% end of the range in a traditional analysis); the other benefits of the Plan, which justify allowing a somewhat higher return; and the prospect that Verizon will be unable to exercise the maximum pricing flexibility authorized by the plan, which would reduce the forecast return below 13.9%. Staff notes as well that over the term of the PRP, Verizon has earned below reasonable levels on both its own calculations and Staff's. Overall, in Staff's judgment, "given the Plan benefits, risks that confront Verizon in transitioning to competition, and the Commission's general reservation of authority, this Plan produces just and reasonable rates."[19]

Competitors' Statements

1. WorldCom

Urging us to adopt the terms of the Joint Proposal, WorldCom cites its recognition of the need for additional competitive enhancements to ensure that the local telephone

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[17] Verizon's own calculations in fact differ somewhat from these, but the difference is not significant for decisional purposes.

[18] Staff's Prefiled Testimony, p. 64.

[19] Staff's Prefiled Testimony, p. 83.

market in New York remains open and to promote active competition across all market segments. In WorldCom's view, the Plan's provisions, together with the recent reductions in UNE rates, should further our pro-competitive regulatory policies. It suggests that some aspects of the plan "could have been stronger in some respects,"[20] but it expects that those matters will be addressed in other proceedings here and before the Federal Communications Commission.

2. Z-Tel

Noting that the recent UNE rate reductions will lead Z-Tel to resume marketing efforts for residential customers in New York, Z-Tel cites the timing and certainty of the Joint Proposal as factors giving it significant value. It notes Verizon's agreement not to challenge the UNE rates and the assurance that the UNE platform will be available for at least two years for small business customers with up to 18 lines. It appends a study showing the benefits to competition and small business customers likely to flow from that provision. Z-Tel also endorses the $15 million pool related to switching refunds, though it suggests the full amount of overpayments would substantially exceed it.

Z-Tel supports the service quality provisions of the Plan because the quality of the service received by Z-Tel and other CLECs from Verizon at wholesale is generally required to be on a par with the service quality that Verizon provides to its retail customers. Z-Tel identifies as well some of the issues it believes may be productively addressed by the task forces created under the plan.

Z-Tel expresses support for our policy of encouraging the development of competitive markets and of using "output oriented, performanced based approaches to regulate areas that are not competitive."[21] Noting that competitive entry has stagnated over the last six months, Z-Tel suggests that the

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[20] WorldCom's Statement in Support, p. 2.

[21] Z-Tel's Prefiled Testimony, p. 9.